

I. BACKGROUND OF AUDIT COMMITTEE INVESTIGATION

A. The Disclosure Crisis

The City of San Diego (“the City”), through plans proposed in 1996 and 2002 by its City Manager and with the consent of its City Council and pension trustees, deliberately underfunded its pension system. These proposals, known as Manager’s Proposal 1 (“MP-1”) and Manager’s Proposal 2 (“MP-2”), enhanced retirement benefits for members of the San Diego City Employees’ Retirement System (“SDCERS”) and reduced the City’s contribution into SDCERS to a negotiated rate lower than that required by an actuary.¹ These actions resulted in two related problems. First, chronic underfunding of the pension system created a large and growing gap between the City’s pension obligations and the resources set aside to meet those obligations. Second, neither the MP-1 or MP-2 agreements themselves, nor many of the financial consequences that flowed from them, were properly disclosed in the City’s financial statements and public disclosures from 1996 through 2002. The combination of a severe pension financing problem and serious disclosure irregularities triggered a series of investigations, both internal and external, into the City’s accounting, disclosure practices, and potential illegal acts that have cast a dark shadow across San Diego.

In September 2003, while the City’s finance staff was working on an offering statement for a sewer revenue bond offering, a member of the SDCERS Board of Trustees, Diann Shipione, discovered a series of accounting and disclosure errors which called into question the accuracy of the City’s comprehensive annual financial reports (“CAFRs”).² This discovery spurred an internal investigation by the City, which revealed a complicated web of disclosure failures, some wholly unrelated to those first discovered by Ms. Shipione.³ By late Fall 2003, the City and its outside disclosure counsel, Paul Webber of Orrick, Herrington & Sutcliffe, decided the situation would require the City to file a voluntary disclosure statement.⁴ The filing of a Voluntary Disclosure with the four Nationally Recognized Municipal Securities Information Repositories in January 2004 (and again in March 2004)⁵ set off a wave of investigations into the City’s pension system,

¹ City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal); San Diego, Cal., Ordinance O-19121 (Nov. 18, 2002); San Diego City Council Resolution R-297336 (Nov. 18, 2002).

² E-mail from Diann Shipione Shea to Lawrence Grissom cc to Richard Murphy, Rick Roeder, and Fred Pierce (Sept. 5, 2003).

³ E-mail from Terri Webster to Russell Gold, Timothy Pestotnik, Dan Deaton, Paul Webber, Les Girard, Bruce Herring, Cathy Lexin, and Patricia Frazier (Sept. 7, 2003); Interview by Vinson & Elkins with Paul Webber (Mar. 5, 2004).

⁴ E-mail from Paul Webber to Ed Ryan cc to Les Girard (Nov. 14, 2003); Interview by Vinson & Elkins with Paul Webber (Mar. 5, 2004).

⁵ City of San Diego, Voluntary Reports of Information from the City of San Diego to the Municipal Securities Rulemaking Board (Jan. 27, 2004, Mar. 12, 2004, and Mar. 26, 2004).

Wastewater Department, and disclosure practices, and eventually led to the formation and work of this Audit Committee.

B. The Investigations

Soon after the City's first Voluntary Disclosure, the United States Securities and Exchange Commission ("SEC") launched an informal inquiry into the City's disclosure practices and its funding of SDCERS. In February 2004, the SEC served the City with its first document requests, and the SEC supplemented those requests on a regular basis over the ensuing months.⁶ The SEC also issued a series of subpoenas that incorporated many of its earlier document requests, and made additional requests for documents.⁷ The SEC expanded its investigation to examine whether the City violated state and federal guidelines governing the setting of sewer rates, and whether the City properly disclosed any such compliance problems in its bond offering disclosures.⁸

The United States Attorney's Office for the Southern District of California ("U.S. Attorney's Office") also commenced an investigation into the City's disclosure practices and its funding of SDCERS, as well as issues pertaining to the City's sewer rates and disclosure issues pertaining thereto. From December 22, 2004, through November 18, 2005, the U.S. Attorney's Office issued 18 subpoenas to the City.⁹ On January

⁶ SEC Document Requests to Custodian of Records, City of San Diego (Feb. 12, 2004, Feb. 18, 2004, Mar. 4, 2004, Apr. 17, 2004, and June 6, 2005).

⁷ Letter from Emily A. Breckenridge, Attorney, U.S. Securities and Exchange Commission, to Custodian of Records, City of San Diego, c/o Paul S. Maco, Esq., with attached SEC Subpoena re: City of San Diego Bond Offerings (LA-2842) (Apr. 22, 2004); Letter from Catherine A. Wimberly, Attorney, U.S. Securities and Exchange Commission, to Custodian of Records, City of San Diego, c/o Paul S. Maco, Esq., with SEC Subpoena re: City of San Diego Bond Offerings (LA-2842) (Apr. 5, 2005). The SEC has also issued subpoenas to various individual City employees and officials, including Lamont Ewell, Les Girard, Rudy Graciano, Lisa Irvine, Phil Phillips, Kelly Salt, and Cecilia San Pedro (Dec. 16, 2004); Lakshmi Kommi, Cathy Lexin, Mary Vattimo, and Terri Webster (Jan. 12, 2005); Patricia T. Frazier and Michael Uberuaga (Feb. 23, 2005); John Kern (Feb. 28, 2005); Paul Barnett (Apr. 7, 2005); Councilmember Toni Atkins, Jeff Gattas and Ed Ryan (Apr. 8, 2005); Clint Carney (Apr. 15, 2005); Scott Crider, Karen Hernandez, Bruce Herring, Councilmember Jim Madaffer, Councilmember Brian Maienschein and Darlene Morrow-Truver (May 5, 2005); and Dennis Gibson (May 6, 2005).

⁸ Letter from Catherine A. Wimberly, Attorney, U.S. Securities and Exchange Commission, to Custodian of Records, City of San Diego, c/o Paul S. Maco, Esq., with SEC Subpoena re: City of San Diego Bond Offerings (LA-2842) (June 30, 2005).

⁹ Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 04-051-SDP-JBO (Dec. 22, 2004); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-057-SDP-JAF (Jan. 11, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-062-SDP-JAF (Jan. 21, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-067-SDP-JAF (Feb. 9, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-070-SDP-JAF (Feb. 11, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-071-SDP-JAF (Feb. 11, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-073-SDP-JAF (Feb. 25, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-074-SDP-JAF (Mar. 8, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-085-SDP-JAF-JBO (May 10,

6, 2006, a federal grand jury indicted five SDCERS Board and staff members on various criminal allegations, including Conspiracy to Commit Wire and Mail Fraud, Wire Fraud, Mail Fraud, and Aiding and Abetting, related to their alleged roles in the underfunding of the pension system.¹⁰ The federal criminal case has not yet proceeded to trial.

In addition to the federal investigations by the SEC and the U.S. Attorney's Office, the State of California, through the San Diego District Attorney, initiated two actions against several individuals related to their participation in activities leading to the pension crisis.¹¹ These actions allege violations of California Government Code Section 1090 and the California Political Reform Act of 1974, which prohibits public officials from using their official positions for financial gain.¹² The State alleges that the defendants, SDCERS Board members and City officials, participated in decisions to underfund the pension system for their own economic benefit.¹³

On February 11, 2004, shortly after filing its first Voluntary Disclosure, the City Council engaged the law firm of Vinson & Elkins LLP ("Vinson & Elkins" or "V&E") to "conduct an internal review

2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-086-SDP-JAF-JBO (May 18, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-099-SDP-JAF-JBO (June 9, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-110-SDP-JAF-JBO (July 26, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-116-SDP-JAF-JBO (Aug. 8, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-118-SDP-JAF-JBO (Aug. 10, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-128-SDP-JAF-JBO (Sept. 22, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-129-SDP-JAF-JBO (Sept. 23, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-145-SDP-JAF-JBO (Nov. 8, 2005); Subpoena to Testify Before Grand Jury, U.S. Dist. Ct. for the S.D. Cal., to Custodian of Records, City of San Diego, 05-148-SDP-JAF-JBO (Nov. 18, 2005).

¹⁰ Indictment, *U.S. v. Saathoff*, No. 06CR0043-BEN (S.D. Cal. Jan. 6, 2006). The following individuals were indicted: SDCERS Board members Ronald Saathoff, Cathy Lexin and Teresa Webster and SDCERS staff members Lawrence Grissom and Loraine Chapin.

¹¹ *People v. Lexin*, No. CD 190930 (Cal. Super. Ct. May 17, 2005); *People v. Grissom*, No. GIC 850246 (Cal. Super. Ct. July 6, 2005).

The Audit Committee, in deference to the state and federal authorities, did not investigate the conduct at issue in these criminal proceedings for the purpose of reaching conclusions regarding possible violations of these criminal laws. Thus, to the extent not addressed, no thing in this Report can be taken as expressing a view on these matters.

¹² *People v. Lexin*, No. CD 190930 (Cal. Super. Ct. May 17, 2005); *People v. Grissom*, No. GIC 850246 (Cal. Super. Ct. July 6, 2005).

¹³ *People v. Lexin*, No. CD 190930 (Cal. Super. Ct. May 17, 2005); *People v. Grissom*, No. GIC 850246 (Cal. Super. Ct. July 6, 2005). Individually-named defendants from the SDCERS Board and staff in these two actions include: Cathy Lexin, Ronald Saathoff, John Anthony Torres, Mary Vattimo, Teresa Webster, Sharon Wilkinson, Lawrence Grissom, Bruce Herring, Loraine Chapin, and Doe Defendants 1 through 25. A "Doe Defendant" is a defendant whose identity is currently unknown.

of City disclosure relating to pension matters in its municipal bond offerings from 1996 to the present and prepare a report with observations, conclusions and recommendations.”¹⁴ According to Vinson & Elkins, no limitations were placed on who it could speak with, documents it could review, or the scope and content of its report.¹⁵ In addition to conducting its investigation into disclosure practices, Vinson & Elkins was also asked by the City to serve another role: to represent the City in the SEC investigation, which was examining the same disclosure practices.¹⁶ Vinson & Elkins was thus called upon to reach independent conclusions about the disclosure practices of the City and many of its senior officials while simultaneously defending the City in an investigation of possible illegal or improper acts. Vinson & Elkins was aware of the conflict, but partner Paul Maco dismissed the resulting concern when it was raised by City Attorney Casey Gwinn.¹⁷

Finally, San Diego City Attorney Michael Aguirre, Mr. Gwinn’s successor, began an investigation shortly after taking office in December 2004. City Attorney Aguirre has published a series of “interim” reports, covering a number of issues related to the pension crisis, including possible abuse, fraud or illegal acts by City and SDCERS officials and employees, and one report related to disclosure failures in connection with the City’s wastewater system.¹⁸

¹⁴ Letter from Paul S. Maco, Vinson & Elkins LLP, to Casey Gwinn, San Diego City Attorney (Feb. 18, 2004); Paul S. Maco and Richard C. Sauer, Vinson & Elkins LLP, Untitled Document Discussing Procedures and Methodology Accompanying Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 3 (Draft July 15, 2005).

¹⁵ Paul S. Maco and Richard C. Sauer, Vinson & Elkins LLP, Untitled Document Discussing Procedures and Methodology Accompanying Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals at 3 (Draft July 15, 2005).

¹⁶ Letter from Paul S. Maco, Vinson & Elkins LLP, to Casey Gwinn, San Diego City Attorney (Feb. 18, 2004) (“We appreciate being asked to represent the City of San Diego in connection with the Securities and Exchange Commission’s (“SEC”) inquiry”). Prior to these engagements, Paul Maco and Vinson & Elkins had represented the City in disclosure-related matters. *See, e.g.*, Agreement for Electronic Disclosure Counsel Services dated January 30, 2003; E-mail from Lakshmi Kommi to Paul S. Maco (Nov. 10, 2003); E-mail from Paul S. Maco to Terri Webster (Nov. 24, 2003); Handwritten notes from Terri Webster (Nov. 26, 2003) (memorializing advice provided by Paul Maco regarding the City’s potential voluntary disclosure).

¹⁷ E-mail from Paul S. Maco to Casey Gwinn cc to Les Girard (Feb. 16, 2004). City Attorney Gwinn told Mr. Maco that Auditor and Comptroller Ed Ryan and Deputy City Manager Pat Frazier had “raised questions about your representation of the City since you were already assisting City staff on these issues. . . . Pat made the point that they were going to have you do an internal review and now you are ‘investigating’ the staff you have been working with.” *Id.* In his response to Mr. Gwinn and his deputy, Les Girard, Mr. Maco wrote that “We see no conflict in our serving in both the report capacity and as your SEC lawyers, rather it is complementary and will avoid doubling up cost. . . . We would also be well positioned to engage in any negotiations with the SEC staff upon completion of the report.” *Id.* Vinson & Elkins’s cursory analysis of the conflict, in which it failed to discuss the pros and cons of its representation beyond stating “We see no conflict,” compromised its investigation from the start.

Former City Attorney Gwinn refused to be interviewed by the Audit Committee.

¹⁸ City Attorney Michael J. Aguirre, Interim Report No. 1 Regarding Possible Abuse, Fraud, and Illegal Acts by San Diego City Officials and Employees (Jan. 14, 2005); City Attorney Michael J. Aguirre, Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials (Feb. 9, 2005); City Attorney Michael J. Aguirre, Interim Report No. 3 Regarding Violations of State and Local Laws as Related to the SDCERS Pension

C. KPMG's Engagement to Audit the City's Financial Statements

In April 2004, after the SEC began its investigation, the City replaced its previous outside auditors, CJO (Calderon, Jaham & Osborn), with KPMG.¹⁹ In its April 13, 2004 engagement letter, KPMG provided the City with an overview of its requirements to complete its audit of the City's financial statements, and its need for reliable and accurate information.²⁰ It also told the City it would need "complete and unrestricted access to the [Vinson & Elkins] Investigation," including "the scope of the Investigation . . . , procedures performed, people interviewed, interview notes or memoranda, [and] other paper and electronic data collected"²¹ KPMG warned the City at the beginning of its engagement:

We will not issue our auditors' report on the City's basic financial statements until such Investigation is complete. In the event that KPMG determines that the Investigation or any aspect thereof is insufficient to allow us [to] complete our audit of the City's basic financial statements or any fund financial statements, KPMG may modify our report or withdraw from the engagement.²²

Among the standards cited by KPMG were Government Auditing Standards which require an auditor to attain "reasonable assurance" about whether the financial statements are free of material misstatements arising from illegal acts that have a direct and material effect on the determination of financial

Fund (Apr. 9, 2005); City Attorney Michael J. Aguirre, Interim Report No. 4 Regarding Additional Funding for Outside Professionals Reviewing Alleged Illegal Acts (May 9, 2005); City Attorney Michael J. Aguirre, Interim Report No. 5 Regarding the Legal Status of the Elected Officers Retirement Program (May 18, 2005); City Attorney Michael J. Aguirre, Amended Interim Report No. 6 Regarding the San Diego City Employees' Retirement System Funding Scheme (July 1, 2005); City Attorney Michael J. Aguirre, Wastewater Interim Report No. 1 City of San Diego Officials' Failure to Disclose Material Facts in Connection with the Offer and Sale of Wastewater Bonds and Related Improper Activity (Sept. 15, 2005); City Attorney Michael J. Aguirre, Interim Report No. 7 SDCERS Attorney-Client Privilege Documents Released Under Federal Court Order (Dec. 6, 2005); City Attorney Michael J. Aguirre, Interim Report No. 8 Report on Kroll's Breach of Legal Duties Owed to the City of San Diego (Apr. 13, 2006); City Attorney Michael J. Aguirre, Interim Report No. 9 Report on Breach of Contract, Fiduciary Duties, and Professional Negligence by Vinson & Elkins LLP (July 26, 2006); and City Attorney Michael J. Aguirre, Interim Report No. 10 Report to Auditor Related to Improper Billing Practices for Service Level Agreements with City of San Diego Water and Wastewater Departments (July 28, 2006).

¹⁹ The City Attorney has sued CJO, Caporicci & Larson, and other entities, alleging that the City's bond offerings and financial statements contained false and inaccurate information regarding SDCERS from 1996 until the voluntary disclosures in 2004. Allegations include claims for professional negligence, breach of fiduciary duties, and breach of contract for the role played by CJO and Caporicci & Larson in assisting the City to prepare disclosure documents that contained false and inaccurate statements that were disseminated to the public. Complaint, *City of San Diego v. Orrick, Herrington & Sutcliffe*, No. GIC 857632 (Cal. Super. Ct. Nov. 30, 2005).

²⁰ Letter from Steven G. DeVetter, Partner, KPMG LLP, to Lisa Irvine, Director, Financial Management Department (Apr. 13, 2004).

²¹ Letter from Steven G. DeVetter, Partner, KPMG LLP, to Lisa Irvine, Director, Financial Management Department (Apr. 13, 2004).

²² Letter from Steven G. DeVetter, Partner, KPMG LLP, to Lisa Irvine, Director, Financial Management Department (Apr. 13, 2004).

statement amounts.²³ Where an auditor has information that an illegal act may have occurred, he should assess whether or not it is likely that one occurred. Further, if an auditor is aware of a possible illegal act, the auditor “should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements.”²⁴ If the auditor does not receive sufficient information to make such an evaluation, the auditor may “[a]pply additional procedures, if necessary to obtain further understanding of the nature of the acts.”²⁵ An auditor “may insist on an investigation in order to conclude on the effect of the possible illegal act on the financial statements.”²⁶ When an illegal acts investigation is conducted, the auditor is to review the scope of the procedures, conclusions, and suggested remedial actions and evaluate the conclusions to determine how they affect the audit.²⁷

Upon gaining an understanding of Vinson & Elkins’s investigative approach, KPMG expressed concern that the scope of Vinson & Elkins’s investigation was not sufficient. At a meeting with KPMG on August 27, 2004, the City and Vinson & Elkins “made it clear . . . that V&E was not retained to investigate issues relating to intent or whether any individual’s conduct violated any law, rule or regulation, and that the scope of its investigative efforts were not designed to do so.”²⁸ KPMG viewed such an approach as inadequate. KPMG also told Vinson & Elkins it should “consider conducting independent electronic discovery” instead of limiting its review to documents gathered in response to the SEC subpoena.²⁹ On multiple occasions, KPMG informed the City that it would likely need additional investigative procedures performed in order to reach conclusions on these issues.³⁰

On September 16, 2004, Vinson & Elkins issued a report entitled “The City of San Diego, California’s Disclosures of Obligation to Fund the San Diego Employees Retirement System and Related Disclosure Practices 1996 - 2004 with Recommended Procedures and Changes to the Municipal Code” (the

²³ United States General Accounting Office, Government Auditing Standards § 4.18 (June 2003).

²⁴ American Institute of Certified Public Accountants, AICPA Professional Standards, AU § 317.10.

²⁵ American Institute of Certified Public Accountants, AICPA Professional Standards, AU § 317.10(b).

²⁶ American Institute of Certified Public Accountants, Practice Alert 2004-01, Illegal Acts at J2 (Nov. 2004).

²⁷ American Institute of Certified Public Accountants, Practice Alert 2004-01, Illegal Acts at J2 (Nov. 2004).

²⁸ Letter from Steven G. DeVetter, Partner, KPMG, to Leslie J. Girard, Assistant City Attorney (Oct. 11, 2004); Letter from Steven G. DeVetter, Partner, KPMG, to Leslie J. Girard, Assistant City Attorney (Sept. 1, 2004). Both letters discuss concerns expressed by KPMG at the August 27, 2004 meeting.

²⁹ Letter from Steven G. DeVetter, Partner, KPMG, to Leslie J. Girard, Assistant City Attorney (Aug. 9, 2004).

³⁰ Letter from Steven G. DeVetter, Partner, KPMG, to Leslie J. Girard, Assistant City Attorney (Oct. 11, 2004). Additionally, SDCERS had not yet provided documents to V&E that were considered to be relevant and necessary to complete the investigation.

“2004 V&E Report”).³¹ The 2004 V&E Report was limited to the disclosure issues Vinson & Elkins had informed KPMG it had investigated and it concluded “that the City’s procedures, policies and practices for disclosure and financial reporting are inadequate in major respects.”³² Despite this statement, the 2004 V&E Report did not contain conclusions as to violations of law and generally failed to address the individual culpability of City officials and employees.

On October 11, 2004, KPMG informed the City that Vinson & Elkins had failed to conduct an adequate investigation.³³ KPMG advised the City that both the scope of the investigation and the procedures used by Vinson & Elkins had failed to “provide a reliable basis for reaching a conclusion as to whether City officials engaged in intentional misconduct or other conduct, which violated any law, rule or regulation having the force of law.”³⁴ According to KPMG, Vinson & Elkins had not conducted either comprehensive interviews or a comprehensive document review. Further, it had failed to sufficiently document its procedures so that KPMG could properly evaluate its work. KPMG (again) told the City that it required additional investigative procedures that led to clear conclusions.³⁵

In response to these concerns, the City Attorney’s Office sent KPMG a proposed “Investigation Program” in which Vinson & Elkins would conduct some additional interviews.³⁶ KPMG rejected this proposal as insufficient, as it failed to provide for appropriate document collection and review.³⁷ In an October 28, 2004 letter to Assistant City Attorney Leslie Girard, Paul Maco expressed Vinson & Elkins’s frustration with the critique of its investigation, stating that “KPMG’s current position would require counsel to speculate on an unbounded universe of unasserted claims.”³⁸ In response to this letter, KPMG informed the City that Mr. Maco’s comments seriously impaired the prospects for a prompt resolution of the matter in light of his unwillingness to provide KPMG with the information and procedures necessary to

³¹ Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California’s Disclosures of Obligation to Fund the San Diego Employees’ Retirement System and Related Disclosure Practices 1996–2004 with Recommended Procedures and Changes to the Municipal Code (Sept. 16, 2004).

³² Letter from Steven G. DeVetter, Partner, KPMG, to Leslie J. Girard, Assistant City Attorney (Oct. 11, 2004); Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California’s Disclosures of Obligation to Fund the San Diego Employees’ Retirement System and Related Disclosure Practices 1996–2004 with Recommended Procedures and Changes to the Municipal Code at 8 (Sept. 16, 2004).

³³ Letter from Steven G. DeVetter, Partner, KPMG, to Leslie J. Girard, Assistant City Attorney (Oct. 11, 2004).

³⁴ Letter from Steven G. DeVetter, Partner, KPMG, to Leslie J. Girard, Assistant City Attorney (Oct. 11, 2004).

³⁵ Letter from Steven G. DeVetter, Partner, KPMG, to Leslie J. Girard, Assistant City Attorney (Oct. 11, 2004).

³⁶ Letter from Steven G. DeVetter, Partner, KPMG, to Leslie J. Girard, Assistant City Attorney (Oct. 27, 2004).

³⁷ Letter from Steven G. DeVetter, Partner, KPMG, to Leslie J. Girard, Assistant City Attorney (Oct. 27, 2004).

³⁸ Letter from Paul S. Maco, Vinson & Elkins, to Leslie J. Girard, Assistant City Attorney (Oct. 28, 2004).

conduct its audit.³⁹ KPMG urged the City to retain new counsel to undertake an appropriate investigation, and observed that there was an apparent tension between the kind of investigation it required and Vinson & Elkins's ongoing representation of the City before the SEC.⁴⁰

KPMG's inability to get reliable information as to what exactly had occurred was not resolved when the City Attorney's Office began to issue its investigative reports in early 2005. These reports offered starkly different conclusions than those reached by Vinson & Elkins and did not hesitate to reach conclusions about illegal acts and the persons responsible for them. Like Vinson & Elkins's investigation, however, the City Attorney's investigation was not independent and did not employ investigative procedures that could be properly evaluated. The City Attorney, like Vinson & Elkins, represented the City in addition to investigating it. And although the City Attorney reports reached strong conclusions, they often did so based on superficial analysis lacking in consistent, persuasive support.⁴¹ In early February 2005, KPMG wrote to Mayor Richard Murphy, City Manager Lamont Ewell, and City Attorney Michael Aguirre that the existence of two investigations demonstrated the importance of identifying some official or body to "take ultimate responsibility for the oversight and completion of an adequate investigation, ensure that a full and complete report of all relevant matters is made to the City Council, and deliver to KPMG the representations necessary to the completion of a financial statement audit in these circumstances."⁴²

D. The Engagement of Kroll and the Formation of the Audit Committee

In February 2005, the City Council passed a resolution to retain Kroll, Inc. ("Kroll") to evaluate the investigative reports of Vinson & Elkins and the City Attorney and to make appropriate

³⁹ Letter from Steven G. DeVetter, Partner, KPMG, to Honorable Dick Murphy, Mayor, and Lamont Ewell, City Manager (Oct. 29, 2004).

⁴⁰ Letter from Steven G. DeVetter, Partner, KPMG, to Honorable Dick Murphy, Mayor, and Lamont Ewell, City Manager (Oct. 29, 2004).

⁴¹ City Attorney Aguirre's first six Interim Reports, issued in just over a five-month span in the first half of 2005, take up a wide array of issues, including MP-1, MP-2, and the City's administration of the pension system. In support of many of his legal conclusions, Mr. Aguirre cites liberally to case law and other sources, though often does not thoroughly explain how such authority supports his broad legal conclusions. *See, e.g.*, City Attorney Michael J. Aguirre, Interim Report No. 2 Regarding Possible Abuse, Illegal Acts and Fraud by City of San Diego Officials at 89-92 (Feb. 9, 2005) (listing approximately twenty SEC municipal enforcement actions without legal analysis); City Attorney Michael J. Aguirre, Amended Interim Report No. 6 Regarding the San Diego City Employees' Retirement System Funding Scheme at 21 (July 1, 2005) (listing case law without legal analysis in support of proposition that City Manager Jack McGrory acted as a fiduciary to SDCERS members by making representations about MP-1). At times, Mr. Aguirre relies on antiquated case law in support of his conclusions. *See, e.g.*, City Attorney Michael J. Aguirre, Amended Interim Report No. 6 Regarding the San Diego City Employees' Retirement System Funding Scheme at 53-56 (July 1, 2005) (citing largely to cases from 1857, 1870, 1882, 1896, 1907, 1913 and 1930 in discussing the City's financial requirements and limitations under the City Charter and the California Constitution). Much of the legal analysis in the City Attorney Reports is results-oriented and bereft of intrinsic credibility.

⁴² Letter from Steven G. DeVetter, Partner, KPMG, to Honorable Dick Murphy, Mayor, Lamont Ewell, City Manager, Michael Aguirre, City Attorney, and Paul S. Maco, Vinson & Elkins (Feb. 3, 2005).

recommendations to the City Council.⁴³ Under the terms of the engagement letter with Kroll (signed by Mayor Murphy, City Manager Ewell, and City Attorney Aguirre), Arthur Levitt, the former Chairman of the SEC, Lynn Turner, former Chief Accountant of the SEC, and Troy Dahlberg, Kroll Managing Director in charge of Forensic Accounting and Litigation Consulting for the West Coast, were also to perform any additional procedures deemed necessary to “reach conclusions or obtain evidential matter that is required by KPMG.”⁴⁴ Kroll was to perform its services “with complete independence from the Council, the Mayor, the City of San Diego . . . the City’s departments, the City’s agencies including [SDCERS], all elected City officials or any other party that is involved with this matter.”⁴⁵

On March 2, 2005, Kroll attended a meeting with representatives from the SEC and U.S. Attorney’s Office, at which Mayor Murphy, two City Council members, the City Manager, and the City Attorney were informed that the SEC staff believed the City had been uncooperative with the federal investigations.⁴⁶ The City was told it needed to comply fully with all outstanding subpoenas, complete its own thorough investigation in order to share information with those agencies, and develop a plan for remediation.⁴⁷ The SEC staff statements were in accordance with pre-established criteria for cooperation known as “the Seaboard standards,” issued by the SEC in 2001 to evaluate whether to take enforcement action against a reporting company for violations resulting from employee misconduct.⁴⁸

⁴³ San Diego City Council Resolution R-300139 (Feb. 14, 2005); Letter from Troy Dahlberg, Managing Director, Kroll Associates, Inc., to Honorable Richard Murphy (Feb. 10, 2005). The resolution to retain Kroll passed by a 9-0 vote with Council members Scott Peters, Michael Zucchet, Toni Atkins, Anthony Young, Brian Maienschein, Donna Frye, James Madaffer, Ralph Inzunza and Mayor Murphy voting in favor of the resolution. Minutes, San Diego City Council Meeting at 34 (Feb. 14, 2005).

⁴⁴ Letter from Troy Dahlberg, Managing Director, Kroll Associates, Inc., to Honorable Richard Murphy, Mayor of San Diego (Feb. 10, 2005).

⁴⁵ Letter from Troy Dahlberg, Managing Director, Kroll Associates, Inc., to Honorable Richard Murphy (Feb. 10, 2005).

⁴⁶ Letter from Kelly C. Bowers, Assistant Director, Pacific Regional Office, U.S. Securities and Exchange Commission, to Lynn E. Turner (Feb. 23, 2005) (confirming the meeting between the parties); *see also* Phillip J. LaVelle, *Feds Prod City Officials on Pace of Fiscal Probes*, San Diego Union-Tribune, Mar. 3, 2005 (stating that the “strong implication . . . is that the SEC isn’t satisfied with the pace of the city’s investigation into its own finances and its cooperation with federal investigations, including the alleged failure to turn over subpoenaed documents on demand.”).

⁴⁷ Letter from Kelly C. Bowers, Assistant Director, Pacific Regional Office, U.S. Securities and Exchange Commission, to Lynn E. Turner (Feb. 23, 2005); *see also* Phillip J. LaVelle, *Feds Prod City Officials on Pace of Fiscal Probes*, San Diego Union-Tribune, Mar. 3, 2005.

⁴⁸ Report of Investigation Pursuant to Section 21(A) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Securities Act Release No. 44969, 76 S.E.C. Docket 220, 2001 WL 1301408 at *2-4 (Oct. 23, 2001) (setting the criteria for cooperation in agency enforcement actions).

To address these concerns, the City on March 8, 2005 formed an independent Audit Committee consisting of Arthur Levitt, Lynn Turner and Troy Dahlberg.⁴⁹ Like an audit committee of a public company, the City's Audit Committee had the authority to engage independent counsel and other advisors.⁵⁰ The law firm of Willkie Farr & Gallagher LLP, under the direction of partners Benito Romano, former U.S. Attorney for the Southern District of New York, and Michael Young, was later retained as Audit Committee counsel. Additionally, PricewaterhouseCoopers was engaged to perform actuarial analyses for the Audit Committee.

⁴⁹ San Diego City Council Resolution R-300203 (Mar. 8, 2005). The resolution to form an audit committee passed by an 8-0 vote, with Council members Scott Peters, Michael Zucchet, Toni Atkins, Brian Maienschein, Donna Frye, James Madaffer, Ralph Inzunza, and Mayor Murphy voting in favor of the resolution. Councilmember Anthony Young was not present. Minutes, San Diego City Council Meeting at 13-14 (Mar. 8, 2005).

⁵⁰ 15 U.S.C. § 78j-1 (West 2006).